RECIPROCAL OR INTER-INSURANCE AGAINST LOSS BY FIRE

"We get back 85 per cent of the premiums we pay for fire insurance. That is real insurance." So spoke the most successful merchant in a large city, as he began to outline to the writer the advantages he experienced from reciprocal fire insurance. Almost at the same time Rulon S. Wells, commissioner of insurance of the state of Utah, was declaring before the Convention of Insurance Commissioners meeting in Denver[1] that the system was "a snare and a delusion, that it brought into mutual relationship of responsibility varied classes of property owners who would do well to investigate the moral standing of those they are obliged to pay losses for." A glance at the names of merchants and manufacturers signed to inter-insurance contracts proves that some of the most prominent business men in America utilize reciprocal fire insurance. On the other hand, the late John S. Patterson,[2] then commissioner of insurance and banking of Texas, as recently as 1915 made the startling statement that:

> During 1914 the people of Texas were swindled out of not less than one million dollars by so-called inter-insurance, to say nothing of unpaid losses. There were forty-nine exchanges holding certificates from the Department when I came into office on January 23 of this year; today there is not a certificate in force. Out of the above number there were some transacting an honest insurance business; others knew no limit to their rascality.

Evidently, both good and evil have resulted from inter-insurance. To permit business men to avail themselves of the gains from this method of insurance and to guard against at least some of the pitfalls, thirty-one states,[3] most of them within the last six years, have enacted laws regulating the exchange of such contracts. It is the purpose of this paper to explain the operation of a reciprocal exchange[4] and to discuss its methods.

[1] *Insurance Report,* Sept., 1918.

[2] *Reciprocal Insurance, What Is It?* A reprint of an address delivered at Monterey, California, Sept. 23, 1915, to the National Convention of Insurance Commissioners.

[3] Alabama, Arizona, Arkansas, California, Colorado, Florida, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Tennessee, Texas, Virginia, Washington, and Wisconsin. Hawaii, Ontario, Quebec, and British Columbia, also provide for reciprocal insurance.

[4] There are said to be about 150 exchanges in the United States.

Illustration of Reciprocal Insurance. A reciprocal or inter-insurance exchange is a place where business concerns exchange with each other contracts of indemnity against fire and lightning (or other hazard) for certain definite amounts. *A* is insured by *B*, *C*, *D*, and *E*. *B* is insured by *A*, *C*, *D*, and *E*. *C* is insured by *A*, *B*, *D*, and *E*. *D* is insured by *A*, *B*, *C*, and *E*. *E* is insured by *A*, *B*, *C*, and *D*. To make the exchange of contracts each applicant for insurance, called a subscriber, gives a power of attorney to a manager, called the attorney-in-fact, who conducts the exchange. Suppose 101 concerns are to make the exchange, each having authorized the attorney to bind it for a sum not to exceed $1,000 on each risk. If Concern No. 1 wishes $110,000 of insurance, it cannot be had, for there are only 100 other subscribers. It can get a $100,000 policy. The standard fire policy of the state in which the applicant resides is written up. At the end of the policy a clause is added specifying the liability of each signer to be one one-hundredth part of the face, or $1,000, and the signature of each of the hundred other concerns is affixed by the attorney-in-fact. If Concern No. 2 desires a policy for $25,000, it is signed by each of the other concerns under a final paragraph stating that the liability of each is $250. If there are 412 subscribers and each limits his liability on a single risk to $2,000, the largest policy that can be written is 411 times $2,000, or $822,000; on a policy for $25,000 the liability of each subscriber would be $25,000 divided by 411, which is $60.83. The amount of liability, $100, $250, $500, $750, $1,000, $2,000, $2,500, or $10,000, which a subscriber will assume on a single risk is specified in his power of attorney.

Subscriber's Agreement and Power of Attorney. It would be inconvenient for each subscriber to receive and pass on every application for insurance. Therefore each subscriber delegates the power to examine applications and sign policies to the same person, the attorney-in-fact, who is the manager of the exchange. The attorney is thus enabled to do business for all in one place at one time. The instrument which each subscriber gives him is called the "subscriber's agreement and power of attorney." The agreement and the power may be separate, but usually they are together in one document. This instrument specifies all the details of the method and prescribes the duties that may be performed for the subscriber by the attorney-in-fact. Sometimes it is short enough to go on one page of paper, size 8½ by 11 inches;

it may occupy three pages of small print on paper 8½ by 14 inches. The main features of the agreement will be stated in the succeeding paragraphs. The scope of the power of the attorney-in-fact is illustrated by the following extract from one of the shorter agreements:

To exchange indemnity with subscribers at said exchange; to make, issue, change, modify, classify, reinsure or cancel contracts therefor containing such terms, clauses, conditions, warranties and agreements, as he shall deem best and to subscribe such contracts; provided, however, that the amount exchanged for us shall in no case exceed the amount hereinafter subscribed by us; to demand, collect, receive and receipt for all moneys due us or for credit to our account as a subscriber; to give, waive or receive all notices or proofs of loss; to adjust and settle all losses and claims under such contracts or other evidences of indemnity; to perform or waive all agreements or stipulations of any such contracts; to accept or appoint any person to accept service of process; to appear for us in any suits, actions, or proceedings and bring, prosecute, defend, compromise, settle or adjust same; to execute any and all documents and perform any and all acts necessary to effect compliance under any law relating to such contracts or to the exchange of such indemnity; to perform every act not herein specially mentioned that we could ourselves do in relation to any contract hereby authorized; provided, however, that said attorney shall have no power to make us jointly liable with any other subscriber; and every liability of whatever nature he is authorized to incur for us hereunder is to be in every case several and not joint.

Premiums and Expenses. The premium which is paid in advance to the manager is nearly always the same as is charged by the stock fire insurance companies. The manager's compensation is a commission on the premiums. This commission varies according to the character of the business of each exchange. Many exchanges have it fixed at 25 per cent; a wholesale grocers' exchange operates at 20 per cent; department store exchanges get off at 15 per cent or even 10 per cent. What this compensation covers in addition to the services of the manager is illustrated by this quotation from a subscriber's agreement:

It is expressly agreed and understood that they (the managers) shall, out of said compensation, themselves defray all disbursements of every character, except losses, counsel fees, costs and expenses of lawsuits, taxes, legal assessments, expenses of fire control, fees of the advisory committee, and all expenses incident to the investment and custody of funds and securities, and of the adjustment of losses.

The manager himself pays for rent, salaries, traveling expenses, printing, supplies, etc. All premiums after expenses and

losses have been deducted, belong to the subscribers. The most successful group of inter-insurers have regularly saved for themselves 85 per cent of their premiums. Another group has returned amounts equal to 78 per cent of the premiums received. Some exchanges report savings of 50 per cent, some 25 per cent, while others have failed absolutely and produced net losses to their members.

Separate Accounts for Each Subscriber. Since the premiums are the property of the separate subscribers (every contract examined declares there are no joint funds), separate accounts with each member are necessary. Two different methods of accounting are used. *Plan One.* The premium of each subscriber is held in trust for him. Each account is credited with the premium received and with the earnings from the investment of the premium and the accumulated surplus. Each account is debited with its share of expenses and losses. The balance, if there is a credit balance, is the saving of the subscriber from the premium paid. *Plan Two.* The premium paid by a subscriber belongs *pro rata* to the other subscribers who have signed his policy. Each account is credited with its share of every premium received and with the earnings from the investment of the credit balances. Each account is debited with its proper share of expenses and losses. The credit balance, if there is one, is profit realized from the business of insuring fellow-subscribers. By this method a subscriber who carries much less insurance than his fellow-members may receive profits greater than his premiums.

Reserve against Unusual Losses. It is a common rule to require that all savings or profits be allowed to accumulate until a surplus equal to double the subscriber's risk on a single policy is provided. If the risk on each policy is $2,500 or $250, the surplus finally required is $5,000 or $500, respectively. Some agreements provide that this surplus shall grow from partial savings. One provision, for instance, reads: "not to exceed one half of our average savings shall be reserved as net surplus until such surplus shall equal the sum of one hundred dollars." After the desired amount of surplus is reached, the credit balance in excess thereof is returned each year in cash to the subscriber.

Payment of Excess Losses. If current losses are so great as to exceed the amount of current premiums and accumulated profits, what is the liability of each subscriber? Some reciprocals place no limit upon their right to assess subscribers. Some provide that

each insured shall not pay more than his annual premium on any one risk; some that he shall not pay more than one additional premium on any one risk. Such provisions still leave no limit to the liability for aggregate losses. There is a type of agreement in use, however, that attempts to restrict aggregate losses to the annual premium or deposit, by means of payments for reinsurance. The exchanges writing the largest hazards provide that in case of one fire involving several risks the insurance in force must be reduced to make the *pro rata* liability of each subscriber no more than a multiple of, say, four or five times the liability on each risk. The aggregate liability in the case of many single fires is still, as it should be, unlimited. Usually the subscriber authorizes the attorney, in the event that the surplus is insufficient to pay losses, to draw on him, and, if necessary, sue him for the amount, provided the maximum liability of the subscriber has not been reached. Sometimes the agreement calls for a flat sum to be paid on demand in case of excess losses. It is always possible to authorize the attorney to insure the subscriber against excess liability Some of the exchanges provide regularly for the deduction of 5 per cent of the premiums to take care of this cost of reinsurance. Maximum liability is the knottiest problem of the reciprocals. Can you limit liability and still have good insurance? The proper solution is not to weaken insurance by attempting to restrict liability by contract, but to lessen losses by sound underwriting, and not assume the hazard of conflagration. Here is one such plan: "It is our policy not to write more than the equivalent of one risk limit in any one city block or square, and not to write more than the equivalent of five risk limits in any city." When maximum limits are involved the subscriber must know how many risks are about him. If his contract limits his liability on a single risk to $1,000 and to four times that on a single fire, and there are eight other risks in that area besides himself, he is only one half insured against conflagration. If there are only four other risks in that area, he is insured to the face of his policy even if a conflagration occurs.

Withdrawal from Agreement. A subscriber can withdraw from his agreement at any time by giving due notice. Some exchanges require a ten-day notice, some five-day, and one practices a one-day notice. This does not mean that withdrawal can be effected completely within that time. The other policyholders may claim legal notice of cancellation which is five days. Obligations al-

ready incurred must be met. The agreements invariably provide that within thirty days after all obligations are fulfilled, the account shall be closed and the credit balance paid to the retiring subscriber.

Special Class Insurance. The big advantage claimed for reciprocal insurance is that it is more economical. How is it possible to insure for less than is charged by the stock companies, the best of which lead the world in insurance ability? The factory mutuals of New England proved that if only the highest class risks of one kind were studied and accepted the cost could be reduced. This idea is characteristic of the best reciprocals. The manager of a large western exchange says:

> With few exceptions, reciprocal insurance is confined to the service of special classes or particular industries. It is my personal opinion that the plan of reciprocal insurance, as well as of mutual insurance, is best suited to the service of a particular industry or a particular class or classes of risks, which enables the management to become experts concerning those particular classes, and thereby able to give a specialized service, which must necessarily result in a reduced cost.

An examination of the risks of reciprocals shows them to be certain special lines such as bank buildings, steam laundries, steam bakeries, lumber mills, wholesale houses, drug stores, hotels, and department stores. An inter-insurer of hotels and drug stores says: "We write only upon buildings of brick, stone or fireproof construction and the contents therein, in towns or cities with adequate fire protection." One exchange advertises the following safeguards: "Elimination of moral hazard; wide separation of risks; rigid inspections; thorough equipment of automatic sprinklers—no exceptions." The manager of another exchange says:

> The principal features that make for the success of our insurance are the following: No concern worth less than $125,000 is eligible on account of the assessment feature; in other words, he must be strong enough financially to meet an assessment of $20,000 without flinching, if called upon to do so (no assessments have been made for twenty years). No application is approved unless the concern is of the highest commercial standing in the community. Our inspection department is a most important adjunct and we maintain a corps of specially trained men at a very heavy expense, who do nothing but inspect our risks from the Atlantic to the Pacific four times a year. Our subscribers, who are not in business to burn, cheerfully coöperate with our efforts to minimize the fire hazard.

The writer went to a subscriber to this reciprocal and asked him

if he would show him the signatures to his insurance policy. As he read over the names of America's leading merchants, he realized the literal truth of what the attorneys had written him and began to comprehend how it had been possible for this group during twenty-five years to have a loss record of only $536,000 and to pay back to its members a total of $6,000,000 in cash refunds.

The Advisory Committee, or Trustees. The advisory committee is a part of every reciprocal organization. In some cases it is a real power, though in others the opponents of the method declare the members of the committee to be figureheads utilized by profiteering managers. This committee is elected by the subscribers and has three, five, or seven members. In one of the strong exchanges the following provisions apply: (1) The committee must be elected annually; (2) each member must be a person, or member of a firm, or a stockholder or officer of a corporation who is a subscriber; (3) it must have entire control of the care of all funds except the manager's commission; (4) no payments can be made from these funds except by a person or persons designated by the committee; (5) no new subscriber can be admitted without the consent of the committee; (6) any subscriber's membership can be cancelled by the committee; (7) the acts and proceedings of the attorney-in-fact are subject to regulation by the committee; (8) annual meetings of the subscribers must be called by the committee; (9) each member of the committee receives one dollar a year from each subscriber as a fee for his services. In contrast to such adequate powers to guarantee satisfactory management to the subscribers, are the terms of another agreement with reference to the advisory committee. The attorney is authorized to find out whom the subscribers desire for a committee and to appoint them; they are to serve until their successors are chosen (nothing is said as to tenure); funds are to be deposited in a bank designated by the committee; and each check must be countersigned by a member of the committee or a bank or person approved by the committee.

Objections to Reciprocal Insurance. The chief objections to reciprocal insurance have been summarized by John F. Ankerbauer[5] who has been one of the leaders of those opposing the method. They are as follows:

1. *Subscribers do not understand the nature of their obliga-*

[5] *Inter-insurance Information* (Cincinnati: John F. Ankerbauer. Not dated. 32 pages).

tions under the subscriber's agreement; they have little or no knowledge of the obligations incurred for them by their attorney-in-fact. This objection can be met by the subscriber's studying carefully his power of attorney, his articles of agreement, and the reports of his attorney which every agreement should require at frequent intervals. Such study should lead to care in the choice of a reciprocal.

2. *Reserves are inadequate.* This has been true of some reciprocals. An examination by a New York state examiner in 1918 of one reciprocal showed that its liabilities were in excess of its admitted assets. It is true of every exchange that fails. A prospective subscriber should shun a reciprocal unless adequate reserves as required of old-line companies are maintained. He should make sure that there is both a premium reserve and an accumulated surplus as a provision against unusual losses. He should also find out whether a sound policy for investing reserves such as is compulsory for stock companies is carefully followed. Reciprocals with no surplus or a small surplus could completely overcome that lack by requiring subscribers to deposit approved securities with a trustee. Bonds to the amount of $100, $500, or $1,000 deposited by each subscriber would effectively guarantee the full payment of all losses.

3. *The subscriber does not know the identity of his fellow-subscribers who are insuring him.* Unfortunately some exchanges are doing business in such a fashion. They should be forced to change their method by lack of business. Nobody should think of taking insurance from unknowns. Great risk lies with such an exchange described by Commissioner McSwain of South Carolina[6] as "an institution through which an indefinite number of persons unknown to each other, severally assume unknown portions of the total liability on the risks, unknown to the insurers, of all the other insurers, and at the same time become insured by unknown parties under an indefinite and constantly changing number of contracts covering changing proportions of the liability on each risk." A policy should be avoided unless it bears the signatures of those liable upon it. The better exchanges issue policies in this manner, permitting the insured to know the exact amount for which each other subscriber is liable.

4. *Some exchanges mix the business of separate industries when*

[6] *Southern Underwriter,* July 25, 1918, p. 6.

the insurance by groups is supposed to be distinct. If steam laundries, bakeries, and hotels insure each other at the same exchange, each insuring others of the same industry only, it is a misrepresentation when the accounts of resources and liabilities are not kept entirely separate and so reported.

5. *If the attorney does not settle a loss satisfactorily, suit has to be brought against too many persons in too many places.* Most contracts provide that the attorney shall accept process, permitting all suits to be brought in one place. The prospect of legal trouble emphasizes the importance of dealing only with a high-class exchange composed of manager and subscribers of unquestioned responsibility and integrity. Legislation for reciprocal insurance, as pointed out below, attempts to simplify the matter of bringing suits.

6. *It is beyond the power of a corporation to have such insurance unless its charter gives it permission to engage in the insurance business; if such participation is not legal, no liability can accrue.* There have been some court decisions supporting this view. In one state some large concerns have withdrawn from reciprocal exchanges on account of the advice of counsel that the above objection is well taken. The position of inter-insurers is represented by the view of Charles H. Howell of Kansas City, Mo., who is general counsel for the American Reciprocal Association. In a letter to the writer (1917) he says: "No opinion by a court of final jurisdiction has ever so held. On the contrary a number of the courts have upheld the right of business corporations to so provide insurance among themselves covering their own properties." Since authorities differ it becomes necessary in each state to discover the weight of opinion and act accordingly. The uniform reciprocal law which has been adopted in so many states clears up this problem by providing expressly: "Any corporation now or hereafter organized shall, in addition to the rights, powers and franchises specified in its articles of incorporation, have full authority and power as a subscriber to exchange insurance contracts of the kind and character herein mentioned. The right to exchange such contracts is hereby declared to be incidental to the purposes for which such corporations are organized, and as fully granted as the rights and powers expressly conferred upon the corporation."[7] It is said that the constitutionality of such a

[7] Section 9, Ohio House Bill No. 325, 82 General Assembly, Regular Session, 1917.

blanket addition to charters of all corporations will be attacked.

7. Just as serious, in some states, as objection number 6 has been the view of some state insurance departments that *inter-insurance without a license from the state department is contrary to law.* The Insurance Commissioner of West Virginia declared in a bulletin that: "Every citizen who becomes a member of an inter-insurance association is violating the laws of this state and is liable to penalties providing for persons or corporations transacting business without complying with the laws of the state." Before the passage of the reciprocal insurance law by Virginia in 1918 agents in that state were subject to arrest. Persons who wished such insurance went to New York, Chicago, St. Louis, or Kansas City, Missouri, for it, and became parties to agreements with firms and corporations not resident in Virginia. This practice was so general in states not providing by law for reciprocal insurance, that a manager of a western exchange said that he expected to write little more insurance in a certain state after the law was passed than he had been writing before its passage.

8. *A reciprocal insurance agreement forms a partnership; liability cannot be restricted by contract, and each subscriber may be liable for the entire face of the policy.* This objection seems doomed, certainly in states where such insurance is provided for by statute, and in any other state where such a contract is not repugnant to its constitution or statutes. There seems no doubt of the limited liability if the attorney signs each policy separately for each subscriber, and specifies that the liability is several and not joint. If every subscriber has made the same kind of usual agreement, there is no partnership. Every subscriber possesses that agreement in duplicate, or has seen it, so there are no innocent third parties.

9. *The attorney-in-fact has too much intrusted to him; he is an autocrat.* There is great danger here. To safeguard against an incompetent or a dishonest manager, a strong advisory committee or board of trustees must be provided. Unsafe underwriting and insufficient inspection are to be guarded against. In practically every case the manager's compensation comes from a percentage of premiums. He is tempted to assume risks that are less good and to give the applicant the benefit of the doubt. He is less likely to yield if he realizes that, as losses increase, subscribers diminish; but the best restraining influence is to subject him to the control of the subscribers acting through a committee.

10. *The advisory committee does nothing; it trusts the attorney.* Unless the committee is annually elected by the subscribers, given authority over the managers, and paid for their services, this is a real objection. While a competent manager must have a free hand, certain exchanges have trustees who really act as a board of directors. Within the past year the manager of one exchange was retired.

Advantages of Inter-Insurance. The advantages that are claimed for reciprocal insurance are as follows:

1. *The expenses of operation are less, due to dealing with a particular class of risks, permitting specialized service, and the reduction of local commissions to a minimum.* Many exchanges have no local commissions to pay. Some exchanges operate at a low cost, but there are others that have saved little or nothing for their subscribers.

2. *All but high-class risks are eliminated.* This is true for some exchanges and untrue for others.

3. *Frequent inspections by trained inspectors.* This is a great advantage of some of the exchanges. There are others that do very little along this line.

4. *Consolidation of small policies into a large one.* If insurance is bought from stock companies it may be expedient to patronize several agencies and have a large number of small policies. Many companies will not write more than a small part of the insurance of a large concern. The insurance obtainable by the reciprocal method in one policy runs all the way from a small amount up to over one million dollars.

5. *The probable large saving.* Some people have not saved anything; others save 25 per cent to 85 per cent of their premiums.

Legislation. The sweep of legislation to favor reciprocal insurance and to control it indicates that the states recognize both the strength of the reciprocal method and the dangers of its misuse. The main features of such legislation are: (1) to require reciprocals to file copies of their agreement, powers of attorney, and contracts; (2) to make complete reports of their condition to the department of insurance; (3) to compel the maintenance of premium reserves, a minimum amount of business, and the possession at all times of such an amount of quick assets as to make certain their ability to settle at once a heavy loss; (4) to enable a suit to be brought by a claimant in his own county against the attorney, or any, or all of the subscribers by serving process upon

the state insurance commissioner who is declared to be the representative for that purpose of the attorney and each of his subscribers; and (6) to tax the business of reciprocals as other insurance is taxed.

Conclusions. A study of the methods, advantages and disadvantages of reciprocal fire insurance leads one to conclude that the principle is sound, but that such insurance is neither incompetence-proof nor crook-proof. In theory the attorney-manager is the agent of his principal, the subscriber. That is proving to be the soundest practice. The attorney ought to be subject to control by the subscribers. Just as directors are a real force in the management of a bank or insurance company, so the advisory committee ought to be in a position, if need be, to assert its authority over the attorney. It seems contrary to good principle for an agreement to read as one did: "Neither the subscriber or subscribers, has, have, or shall have, any ownership or property interest in or to the business, plan of business, system of indemnity insurance, office or office property of the attorney-in-fact, or any property right in or to said exchange." The manager must be a successful underwriter and a man above reproach, committed to the welfare of his principals, rather than a self-seeking adventurer. All but high-class risks must be eliminated, and rigid, frequent inspection must be enforced. For people who intend to adopt every means of preventing fire, who themselves constitute no moral hazard, whose commercial integrity is the highest, whose several properties are widely scattered, but whose interests draw them so closely together that they have knowledge of each other's integrity, there is a profitable field for reciprocal insurance. For other people the range of liability is so great that the value of the plan is doubtful. *The business man must proceed as carefully in its use as if he were buying stock in a corporation or extending a line of credit.* Instead of getting insurance he may increase his liabilities. Rockefeller's success in oil does not foreordain the success of every oil project. But reciprocal fire insurance wisely conducted excites enthusiastic admiration.

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